

Message Text

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PAGE 01 BONN 10090 01 OF 04 231936Z

67

ACTION EUR-12

INFO OCT-01 EA-06 ISO-00 SP-02 AID-05 EB-07 NSC-05 CIEP-01

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P R 231811Z JUN 75

FM AMEMBASSY BONN

TO SECSTATE WASHDC PRIORITY 0922

INFO AMEMBASSY LONDON

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

USMISSION EC BRUSSELS

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C O N F I D E N T I A L SECTION 01 OF 04 BONN 10090

DEPARTMENT PASS TREASURY, CEA AND FRB

E.O. 11652, GDS

TAGS: EFIN, GW

SUBJECT: MEDIUM-TERM OUTLOOK

REF: STATE 136051 AND BONN 9893

1. SUMMARY. THE EMBASSY FORECASTS AN AVERAGE ANNUAL REAL GROWTH IN GNP OF 2.5 PERCENT OVER THE NEXT FOUR YEARS. THIS IS PREDICATED ON A REAL DROP OF 3 PERCENT IN 1975, WHICH IS IN THE RANGE THE FRG IS CONTEMPLATING. HOWEVER, THE UNEMPLOYMENT LEVELS INHERENT IN THIS GROWTH PATH ARE UNACCEPTABLY HIGH -- OVER TWO MILLION IN THE MEDIUM TERM -- AND A MORE EXPANSIONARY POLICY SEEMS UNAVOIDABLE EVEN IN THE KNOWLEDGE THAT IT WILL REKINDLE INFLATION. THIS POLICY SHIFT WILL BE DELAYED AS LONG AS POSSIBLE, ALTHOUGH POLITICAL PRESSURES (NATIONAL ELECTIONS IN CONFIDENTIAL

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PAGE 02 BONN 10090 01 OF 04 231936Z

FALL 1976) MAY FORCE IT AS EARLY AS NEXT MARCH IF NO

MEANINGFUL UPTURN HAS OCCURRED BY THAT TIME. END
SUMMARY

2. LIKELY GROWTH

WE NOW FORECAST REAL GNP TO DECLINE BY 3 PERCENT IN 1975. ACCORDING TO THE BERLIN INSTITUTE, NON-SEASONALLY ADJUSTED GNP IN THE FIRST QUARTER 1975 WAS DOWN 5 PERCENT FROM WHAT IT WAS IN THE SAME QUARTER LAST YEAR. INDUSTRIAL PRODUCTION IN THE FIRST FOUR MONTHS IS DOWN BY EIGHT PERCENT FROM THE SAME PERIOD LAST YEAR, AND NEW INDUSTRIAL ORDERS IN VOLUME TERMS ARE RUNNING 7 PERCENT BEHIND LAST YEAR FOR THE SAME COMPARISON PERIOD, FORESHADOWING A CONTINUATION NEGATIVE GROWTH FOR SOME TIME. ON THE BASIS OF THIS POOR HEADSTART, NO BETTER ANNUAL RECORD SEEMS POSSIBLE. THE EMBASSY FORECAST IS PREDICATED ON A MOVE TO POSITIVE GNP GROWTH THAT WILL COME IN THE FOURTH QUARTER, WHEN IT WILL PERHAPS REACH A MODERATE 1 PERCENT OVER THE SAME QUARTER THE PREVIOUS YEAR. THE PICTURE FOR 1976 IS ONE OF SLOWLY ACCELERATING GROWTH THAT WILL AVERAGE 4-5 PERCENT FOR THE YEAR, WITH 3 PERCENT, AT AN ANNUAL RATE, IN THE FIRST HALF, AND 6 PERCENT IN THE SECOND HALF. PROJECTING INTO 1977, ACCORDING TO THE GROWTH PATH WE EXPECT, REAL GNP SHOULD INCREASE BY 5 TO 6 PERCENT. THE BUSINESS CYCLE WILL THEN PROBABLY START ITS DESCENT IN 1978, WITH THE GROWTH RATE DROPPING TO 2.5 TO 3.5 PERCENT. THE AVERAGE ANNUAL GROWTH FOR THE 1975-78 PERIOD ENCOMPASSED IN THIS FORECAST, IS 2.5 PERCENT, WHICH MANY NOW FEEL IS THE MEDIUM-TERM POTENTIAL FOR THE FRG RATHER THAN THE 4 PERCENT WHICH HAS BEEN AVERAGE ACTUAL GROWTH FOR THE PAST TEN YEARS. THE SEVERELY REDUCED INVESTMENT RATES OF THE LAST YEARS, THE STRUCTURAL CHANGES THAT HAVE TAKEN PLACE, AND THE MATURATION OF THE GERMAN ECONOMY ALL ACCOUNT FOR THIS LOWERING OF GROWTH POTENTIAL.

GNP REAL GROWTH RATES COMPARING SAME QUARTER
WITH PREVIOUS YEAR
(BERLIN INSTITUTE NON-SEASONALLY ADJUSTED DATA USED AS
BASE)
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PAGE 03 BONN 10090 01 OF 04 231936Z

	AVG FOR				
YEAR	1ST QTR	2ND QTR	3RD QTR	4TH QTR	YEAR
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1975	-5.0	-4.2	-3.8	1.0	-3.0
1976	3.1	3.3	5.9	5.8	4.5
1977	4.8	6.5	6.0	5.2	5.6

1978	3.2	5.5	2.0	1.7	3.1
AVERAGE				2.5	

3. ASSUMPTIONS.

WE ASSUME A GROWTH PATH SIMILAR TO THAT THAT
FOLLOWED THE 1966-67 RECESSION. (IN OUR LAST FORECAST
WE USED THE SAME METHOD, AND SINCE THEN HAVE NOTED THAT

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PAGE 01 BONN 10090 02 OF 04 231832Z

67

ACTION EUR-12

INFO OCT-01 EA-06 ISO-00 SP-02 AID-05 EB-07 NSC-05 CIEP-01

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FM AMEMBASSY BONN

TO SECSTATE WASHDC PRIORITY 0923

INFO AMEMBASSY LONDON

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

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C O N F I D E N T I A L SECTION 02 OF 04 BONN 10090

PROFESSOR GIER SCH, HEAD OF THE KIEL INSTITUTE AND
FORMER MEMBER OF THE COUNCIL OF ECONOMIC ADVISORS, HAS
ADOPTED A SIMILAR APPROACH IN HIS FORECASTING OF THE
FUTURE BEHAVIOR OF THE GERMAN BUSINESS CYCLE.) WE
ADJUST, THOUGH, IN ASSUMING THAT GROWTH RATES WILL NOT
REACH SO HIGH AS PREVIOUSLY SINCE THE TROUGH OF THE

CURRENT RECESSION IS DEEPER THAN IN 1967. ALSO THE BEHAVIOR OF THE COMPONENTS OF GROWTH WILL HAVE TO BE DIFFERENT THIS TIME. MOST NOTABLY, EXPORT GROWTH WILL NOT PLAY THE LEADING ROLE THAT IT FORMERLY DID. THE 13 PERCENT REAL EXPORT GROWTH OF THE 1967-69 RECOVERY PERIOD CANNOT BE DUPLICATED IN 1976-77, THE COUNTERPART YEARS IN THE CURRENT STAGE OF THE CYCLE. NOR DO THE 12 PERCENT INVESTMENT GROWTH RATES OF THAT SAME GENERAL PERIOD SEEM IN THE OFFING. THE LIKELY PERSISTENCE OF DAMPENED DEMAND ABROAD AND LIMITED PROFIT

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PAGE 02 BONN 10090 02 OF 04 231832Z

PROSPECTS CONFRONTING INVESTORS CONTRIBUTE TO THIS CHANGED SITUATION. THIS SCENARIO ALSO DEPENDS ON MODEST WAGE SETTLEMENTS LEADING TO IMPROVED BUSINESS PROFITS. INFLATION WOULD ALSO TEND TO MODERATE WITH THE PUBLIC CONSUMPTION PRICE INCREASE FOR 1975 BEING ABOUT 5.5 PERCENT, WITH A POSSIBLE FURTHER DROP IN 1976, BUT WITH RISES THEREAFTER. A BASIC ASSUMPTION IS THAT THERE WILL BE NO SHORT-RUN ALTERATION IN THE COUNTRY'S PRESENT ECONOMIC POLICY, AND BEYOND THAT POINT THERE WILL BE A GRADUAL MOVE TO MORE RESTRICTIVE POLICIES. ALSO INCORPORATED IN THE ASSUMPTION BASE IS THE ELEMENT OF RELATIVE STABILITY IN THE COSTS OF ENERGY.

4. UNEMPLOYMENT.

THE AVERAGE REAL GROWTH RATE OF 2.5 PERCENT IN GNP THAT THIS SCENARIO INVOLVES WOULD LEAD TO HIGHER UNEMPLOYMENT RATES THAN THE PRESENT 5 PERCENT. THIS IS DUE TO THE FACT THAT ANNUAL PRODUCTIVITY INCREASES IN GERMANY HAVE BEEN AND ARE EXPECTED TO CONTINUE TO BE IN THE RANGE OF 4 PERCENT ANNUALLY. FURTHERMORE, THERE ARE EXPECTED TO BE MORE NEW ENTRANTS INTO THE LABOR FORCE OVER THE NEXT 5 YEARS THAN THE NUMBER OF THOSE THAT WILL LEAVE THROUGH ATTRITION ON ACCOUNT OF THE DEMOGRAPHIC FACTORS INVOLVED. ONE ELEMENT OF FLEXIBILITY IN THIS PICTURE IS THE PRESENCE OF A FOREIGN WORKER COMPLEMENT OF AROUND 2 MILLION OUT OF A TOTAL LABOR FORCE OF SOME 22 MILLION. GIVEN THESE VARIABLES IT WAS VERY DIFFICULT FOR THE EMBASSY TO SPECIFICALLY QUANTIFY THE ANTICIPATED UNEMPLOYMENT RATES OVER THE MEDIUM TERM EXCEPT TO SAY THAT GIVEN THE PROJECTION OF ECONOMIC GROWTH WE HAVE DEVELOPED, UNEMPLOYMENT AT THE END OF THE PERIOD WOULD BE SUBSTANTIALLY HIGHER THAN AT PRESENT.

5. THE FRG VIEW.

A. IN ORDER TO ELICIT THE OPINION ON MEDIUM TERM

DEVELOPMENTS FROM A KNOWLEDGABLE OFFICIAL SOURCE AND TO
TEST OUR OWN PROJECTIONS, ON JUNE 23 WE TOOK THE MATTER
UP WITH ECONOMICS MINISTRY DEPUTY ASSISTANT SECRETARY
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PAGE 03 BONN 10090 02 OF 04 231832Z

RAABE, WHO IS IN CHARGE OF ECONOMIC ANALYSIS AND
FORECASTING. DR. RAABE WAS PARTICULARLY CONCERNED
ABOUT THE CONFIDENTIALITY WITH WHICH HIS VIEWS WILL BE
TREATED AND EVEN SAID THAT HE WOULD HAVE TO DENY THEM
IF THEY EVER GOT BACK TO HIM, GIVEN THE SENSITIVITY OF
THE SUBJECT DISCUSSED.

B. RAABE SAID THAT THE GOVERNMENT IS NOW THINKING IN
TERMS OF A REAL DECLINE FOR GNP IN 1975 IN THE RANGE OF
2 TO 3 PERCENT, THEREBY ROUGHLY CONFIRMING THE EMBASSY'S
PROJECTION. THE LESSER NUMBER WOULD BE IN THE EVENT OF
A SEPTEMBER UPTURN FOR WHICH HE SEES A POSSIBILITY
BUT HAS NOTHING CONCRETE TO SUBSTANTIATE. HE SAID THAT
NOBODY CAN SAY WHEN THE UPSWING WILL COME AND THAT THERE
WAS ONLY ABUNDANT HOPE THAT IT WOULD COME IN THE FALL;
THE QUESTION IS, HE SAID, HALF JOVIALY, "BUT OF WHICH
YEAR?" HE REGRETTED THAT THE ECONOMISTS COULD FIND NO
EXPLANATION FOR THE VERY HIGH SAVINGS RATIOS (1/3 OF
INCREMENTAL CONSUMER INCOME INCREASES ARE BEING SAVED)
AND THE FACT THAT THE PRIVATE INVESTORS WERE NOT ACTING
DESPITE THE PRESENCE OF VERY FAVORABLE CONDITIONS.
THESE FACTORS WERE DELAYING THE ADVENT OF THE UPSWING.
HE SAW THE EXPECTED UPSWING THEREFORE AS STEMMING FROM
A MIXTURE OF SUBSTANTIAL REAL INCREASES ABOVE THE
CURRENT 2.5 PERCENT IN PRIVATE CONSUMPTION TO 6-PLUS
PERCENT (AT LEAST INITIALLY) AND THE RAISING OF

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PAGE 01 BONN 10090 03 OF 04 231837Z

67

ACTION EUR-12

INFO OCT-01 EA-06 ISO-00 SP-02 AID-05 EB-07 NSC-05 CIEP-01

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FM AMEMBASSY BONN

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INFO AMEMBASSY LONDON

AMEMBASSY PARIS

AMEMBASSY ROME

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C O N F I D E N T I A L SECTION 03 OF 04 BONN 10090

INVESTMENT GROWTH TO THE 7 OR 8 PERCENT RANGE REAL
FROM THEIR PRESENT NEGATIVE 3-5 PERCENT.

C. IN NO EVENT, HE SAID, WOULD THE ROLE OF EXPORTS
BE WHAT IT WAS IN THE PAST. IN ANY CASE, HE SAID THERE
WERE TOO MANY "POLITICAL" PROBLEMS IF THE EXPORT GROWTH
WAS AS HIGH AS IN 1974 AND THERE WAS A DEFINITE NEED TO
REDUCE NET EXPORT RATES. HOWEVER, THE PRESENT DOWNTURN
IN EXPORTS IS TOO SHARP AND THERE MUST BE, IN ORDER FOR
SATISFACTORY GERMAN ECONOMIC GROWTH TO BE RESUMED, A
6-8 PERCENT REAL INCREASE IN EXPORTS. FOR THIS REASON
GERMANY WAS ESPECIALLY CONCERNED THAT THE U.S. ECONOMY
SHOULD REVIVE AS IT IS A SIZEABLE EXPORT CUSTOMER (8
PERCENT OF GERMAN EXPORTS WENT TO THE U.S. IN 1974 AND
6 PERCENT SO FAR IN 1975.) EVEN MORE IMPORTANT IS THE
INDIRECT EFFECT SINCE MANY OF GERMANY'S EXPORT CUSTOMERS
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PAGE 02 BONN 10090 03 OF 04 231837Z

ARE HEAVILY DEPENDENT ON THEIR OWN SALES TO THE U.S.

D. RAABE FORECAST A 1975 INCREASE IN PRIVATE
CONSUMPTION PRICES OF 5.5 PERCENT, BUT A GNP DEFLATOR
OF 7.5 PERCENT DUE TO THE SHIFT IN THE TERMS OF TRADE.
FOR 1976 HE THOUGHT THAT 4 - 4.5 PERCENT PRIVATE
CONSUMPTION PRICE INCREASE WAS LIKELY DUE TO THE FACT
THAT HIGH UNEMPLOYMENT WILL KEEP WAGE SETTLEMENTS IN A
REASONABLE RANGE. HE FEARED FOR THE PERIOD THEREAFTER,
AS WILL BE EXPLAINED LATER.

E. RAABE, WHEN SHOWN THE EMBASSY 2.5 PERCENT AVERAGE ANNUAL GNP GROWTH RATE FORECAST FOR THE MEDIUM-TERM, SAID THAT THAT CERTAINLY MATCHES THE CURRENT GROWTH POTENTIAL OF THE GERMAN ECONOMY. BUT HE STATED THAT THERE PRESENTLY EXISTED A 5 PERCENT SLACK IN NORMAL CAPACITY UTILIZATION WHICH COULD BE ADDED TO THE GROWTH POTENTIAL. THIS, HE SAID, WOULD MAKE POSSIBLE A REAL GROWTH RATE OF 7-8 PERCENT IN 1976. HOWEVER, HE DID NOT SAY THAT THAT WAS IN FACT HIS PROJECTION BUT RATHER A STATEMENT OF THE THEORETICAL IDEAL SITUATION. HE RESPONDED TO THE EMBASSY'S ALTERNATIVE, OPTIMISTIC PROJECTION OF 4 PERCENT AVERAGE ANNUAL GROWTH FOR THE MEDIUM-TERM BY SAYING THAT THIS TOO WAS THEIR IDEAL CONCEPTION OF FUTURE DEVELOPMENT.

6. ECONOMIC POLICY AND UNEMPLOYMENT.

A. DR. RAABE SOON MADE IT CLEAR THAT THE PRIMARY CONCERN OF GERMAN POLICY MAKERS IS THE AVOIDANCE OF EXCESSIVE UNEMPLOYMENT. HE SAID THAT TO TALK OF A DECLINING UNEMPLOYMENT RATE (NON-SEASONALLY ADJUSTED) AS SOME ARE IS NONSENSE, AND THAT IN SEASONALLY ADJUSTED TERMS UNEMPLOYMENT IS RISING BY 100,000 EACH MONTH. HE SAW THE SEASONAL PEAK IN JANUARY/FEBRUARY OF 1976 REACHING 1.6 MILLION AND OPINED THAT THIS WAS ABOUT THE MAXIMUM THAT THE GOVERNMENT COULD SUPPORT. FURTHERMORE, HE SAW THE SEASONAL PEAK RISING EACH YEAR WITH 2.2 MILLION PROJECTED FOR 1976-77. HE SAID THAT THE EMBASSY FORECAST OF 2.5 PERCENT AVERAGE GNP GROWTH OVER THE

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PAGE 03 BONN 10090 03 OF 04 231837Z

MEDIUM-TERM WOULD LEAD TO UNEMPLOYMENT OF OVER 2 MILLION IN 1978. HE WAS OBVIOUSLY SPEAKING FROM KNOWLEDGE OF SPECIFIC FORECASTS OF WHAT WOULD HAPPEN IN THE ABSENCE OF ANY ADDITIONAL STIMULUS TO THE ECONOMY, AND LEFT NO QUESTION BUT THAT THIS ACTION WOULD LIKELY COME SINCE TWO MILLION UNEMPLOYED COULD NOT BE COUNTENANCED. THE QUESTION WAS RATHER OF WHEN IT WOULD COME - IN THE SHORT OR MEDIUM TERM. A MEDIUM TERM AVERAGE GROWTH OF 4 PERCENT WOULD IMPLY AN ACCEPTABLE HALF MILLION UNEMPLOYED HE SAID.

B. REGARDING THE FACTOR OF FLEXIBILITY AFFORDED BY THE GUEST WORKERS IN THE LABOR FORCE, HE SAID THAT THEY WERE NOT SO EASY TO SEND BACK HOME. OF THE APPROXIMATELY 2 MILLION PRESENTLY IN THE LABOR FORCE, THE GOVERNMENT ESTIMATES THAT ONLY ABOUT 800,000 COULD BE PHASED OUT AND THERE WOULD BE A RESIDUAL OF ABOUT 1.2 MILLION THAT WOULD REMAIN. THIS REDUCTION IS

TAKEN INTO ACCOUNT IN THE HIGH UNEMPLOYMENT PROJECTIONS
HE CITED.

7. POLITICAL FACTORS

THE SCHEDULING OF PARLIAMENTARY ELECTIONS IN 1976
AND THE IMPACT THIS HAS FOR NATIONAL LEADERSHIP IN
THE FRG MAKE THE HANDLING OF THE UNEMPLOYMENT PROBLEM
ESPECIALLY CRUCIAL. THEREFORE, IF THE UPTURN DOES NOT

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PAGE 01 BONN 10090 04 OF 04 231838Z

67

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INFO OCT-01 EA-06 ISO-00 SP-02 AID-05 EB-07 NSC-05 CIEP-01

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C O N F I D E N T I A L SECTION 04 OF 04 BONN 10090

COME BY MARCH OF 1976 (WHICH HE SAW AS A POSSIBILITY),
HE FORECAST THE NECESSITY OF A MASSIVE STIMULATIVE
EFFORT BY THE GOVERNMENT TO GET THE ECONOMY GROWING AT
A DECENT RATE AND THE UNEMPLOYMENT DOWN BY ELECTION TIME
IN THE FALL OF 1976. THE MARCH DEADLINE FOR ACTION

STEMS FROM THE 6-MONTH LAG TIME HE CALCULATES IT TAKES FROM THE INSTITUTION OF THE MEASURES AND THEIR HAVING A FELT EFFECT. HE SAID THAT WHILE THE POLICY MAKERS ARE WELL AWARE OF THE INFLATIONARY FORCES INHERENT IN ADDITIONAL STIMULATION THEY WOULD PROBABLY RATHER RUN THAT RISK THAN WHAT THEY SEE AS THE EVEN GREATER RISK OF PERMITTING A PERSISTENTLY HIGH UNEMPLOYMENT RATE WHICH COULD NOT ONLY THROW THEM OUT OF POWER BUT BRING GRAVE REPERCUSSIONS FOR THE NATION. THROUGHOUT THE DISCUSSION DR. RAABALSO MADE IT QUITE CLEAR THAT HE WAS WELL AWARE OF THE POSSIBILITY OF A SIMULTANEOUS RESUMPTION
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PAGE 02 BONN 10090 04 OF 04 231838Z

OF STRONG GROWTH IN THE MAJOR INDUSTRIAL COUNTRIES AND THE THREAT THAT THIS WOULD REPRESENT FOR A REKINDLING OF EVEN HIGHER INFLATION RATES THAN HAVE BEEN EXPERIENCED IN THE RECENT PAST. NEVERTHELESS, THE NATIONAL INTEREST CENTERING AROUND UNEMPLOYMENT COME FIRST IN THE GERMAN POLICY MAKERS' THINKING. UNEMPLOYMENT IN THE RANGE OF 2 MILLION WOULD BE IMPOSSIBLE TO SUPPORT AND CLEARLY THIS IS A POTENTIAL POSSIBILITY OVER THE MEDIUM-TERM FUTURE UNLESS THERE IS A SHIFT TO MORE EXPANSIVE ECONOMIC POLICY. HE OBSERVED THAT PAYMENT OF THE PRICE OF A MORE EXPANSIONARY POLICY - I.E., HIGHER INFLATION - THAT MIGHT BE ADOPTED BY THE GOVERNMENT IN MARCH OR SO OF NEXT YEAR WOULD NOT BE MEASURABLE IN COST OF LIVING INCREASES UNTIL SOME 9 MONTHS LATER, OR AFTER THE ELCTIONS. HE IMPLIED THAT, IF NECESSARY, THE POLITICIANS WOULD RESORT TO THIS PRACTICE. FOR THE TIME BEING, HOWEVER, THEY ARE WAITING AND HOPING THAT THE HIGH GROWTH RATES NECESSARY TO AVOID TOO SERIOUS AN UNEMPLOYMENT PROBLEM FOR 1976 WILL COME FROM THE POLICIES ALREADY IN PLACE, ALTHOUGH THERE IS SCANT CONCRETE SUPPORT AT PRESENT THAT THIS WILL BE THE CASE.
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